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# INTRODUCTORY SECTION

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for Fiscal Year ending June 30, 2004



**The Kentucky State Capitol Building**

**Frankfort, Kentucky**

*Kentucky's state house was dedicated to a crowd of about 10,000 people in June 1910. It was the eighth building in Kentucky to serve as the seat of government and was built with extraordinary skill. The Capitol's splendid marble and granite finishes are unique to this era. It would be nearly impossible to build today since the craftsmen with the skills to do this work are now few and far between. Magnificent scenes of the frontier as Daniel Boone saw it, adorn the chambers entrance of the House and Senate. The dome, stairways and reception rooms are modeled after famous French designs. The dome rises 212 feet from the terrace floor to the tip of the lantern which shines at night above the capital city.*

## Chairperson's Letter Teachers' Retirement System of the State of Kentucky



December 9, 2004

Dear Members:

On behalf of the Board of Trustees and staff, I am pleased to present this Comprehensive Annual Financial Report of the Teachers' Retirement System of the State of Kentucky for the year ending June 30, 2004, the 64th year of operation of the System. The accompanying reports from the independent auditor and the consulting actuary substantiate the financial integrity and the actuarial soundness of the system.

KTRS closed the 2003-2004 fiscal year with \$13 billion net assets. The active membership totaled 71,950 and the retired membership was 35,803 with an annual payroll of \$885 million.

The Board of Trustees is totally committed to managing the retirement system funds in a prudent, professional manner. The retirement system is justly proud of the funding level that the system has achieved. Every effort will be made to insure that the system continues to operate in a fiscally sound manner. Present and future members of the system deserve to be able to avail themselves of the best possible retirement as authorized by statute.

We appreciate the support and cooperation extended by the Governor and the Legislature. This cooperation allows the system to not only meet current challenges but to also make timely provisions for the future.

The Board of Trustees pledges to continue to administer the affairs of the Kentucky Teachers' Retirement System in the most competent and efficient manner possible.

Sincerely,

**Virginia Murrell**

Chairperson  
Board of Trustees

### BOARD OF TRUSTEES

**VIRGINIA MURRELL**  
CHAIRPERSON  
SOMERSET

**ARTHUR W. GREEN**  
VICE CHAIRPERSON  
ELKTON

**ROBERT M. CONLEY**  
PAINTSVILLE

**JULIAN M. CARROLL**  
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**STEVEN E. HOSKINS**  
WICKLIFFE

**RUTH ANN SWEAZY**  
TAYLORSVILLE

**LAURA ZIMMERMAN**  
LEXINGTON

*EX OFFICIO*  
**GENE WILHOIT**  
COMMISSIONER  
DEPARTMENT  
OF EDUCATION

*EX OFFICIO*  
**JONATHAN MILLER**  
STATE TREASURER

## Letter of Transmittal



### Teachers' Retirement System of the State of Kentucky

Honorable Ernie Fletcher, Governor  
Commonwealth of Kentucky  
Capitol Building  
Frankfort, Kentucky 40601-3800

December 9, 2004

Dear Governor Fletcher:

It is my pleasure to submit the 64th Comprehensive Annual Financial Report of the Teachers' Retirement System of the State of Kentucky, a Component Unit of the Commonwealth of Kentucky, for the fiscal year ended June 30, 2004.

State law provides the legal requirement for the publication of this report and in addition requires an annual audit of the retirement system.

Kentucky Teachers' Retirement System (KTRS) has produced an annual report that will provide you, the General Assembly, and the general public, with information necessary to gain a better understanding of the Teachers' Retirement System.

#### **This Report Consists of Five Sections:**

- ❖ The Introductory Section contains the Board Chairperson's letter, this letter of transmittal, Board of Trustees information, a list of consultants used by the System, and the organizational chart.
- ❖ The Financial Section contains the report of the independent auditors, management's discussion and analysis, financial statements and required supplementary schedules.
- ❖ The Investment Section presents investment and portfolio performance. This includes the policies, summary, and profile of the System's holdings.
- ❖ The Actuarial Section contains the certification from Mellon Consultants (the consulting actuary service) as well as the results of the System's actuarial valuation.

- ❖ The Statistical Section contains various information on the System's membership, both active and retired. A listing of all participating KTRS employers is also presented in this section.

#### **Accounting System and Reports**

This report has been prepared in conformity with the principles of governmental accounting and reporting as established by the Governmental Accounting Standards Board and the American Institute of Certified Public Accountants. This report was prepared by the Kentucky Teachers' Retirement System accounting department. Responsibility for both the accuracy of the presented data and the completeness and fairness of the presentation, including all disclosures, rests with KTRS. KTRS believes the data, as presented, is accurate in all material aspects; that it is presented in a manner designed to fairly set forth the financial position and results of operations of KTRS as measured by the financial activity of its various funds; and that all disclosures necessary to enable the reader to gain the maximum understanding of KTRS' financial affairs have been included. Discussion and analysis of net assets and related additions and deductions is presented in the MD&A beginning on page 15.

The accrual basis of accounting is used to record the assets, liabilities, revenues, and expenses of the System. Revenues of the System are taken into account when earned without regard to the date of collection, and expenses are recorded when the corresponding liabilities are incurred, regardless of when payment is made. Fixed assets are recorded at cost and depreciated over the estimated useful lives of the assets.

In developing and evaluating KTRS' accounting system, consideration is given to the adequacy of internal accounting controls. Internal accounting controls are designed to provide reasonable, but not absolute, assurance regarding: (1) the safeguarding of assets against loss from unauthorized use or disposition; and (2) the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived; and (2) the evaluation of costs and benefits requires estimates and judgments by management.

All internal control evaluations occur within the above framework. We believe that KTRS' internal accounting controls adequately safeguard assets and provide reasonable assurance of proper recording of financial transactions.

## Revenues

The reserves needed to finance retirement and other member benefits are accumulated through the collection of member, employer or state contributions as well as income derived from the investment of reserve funds. Total additions (contributions and net investment income) for the fiscal year were \$1,779 million for the defined benefit plan, while the additions to the medical insurance plan and the tax-sheltered annuity plan were \$114.4 million and \$5.0 thousand respectively. The overall contribution rates remain the same. However, 1.3% of payroll was assigned to the medical insurance plan rather than the defined benefit plan. As of April 30, 1997, the tax-sheltered annuity plan no longer accepts contributions.

## Expenses

The primary purpose of a retirement system relates to the purpose for which it was created, the payment of benefits. These payments, along with refunds of contributions to terminated employees, insurance benefits of retired teachers, and the cost of administering the system, comprise the total expenses. The total expenses of the tax-sheltered annuity plan were \$41.5 thousand, consisting solely of benefit payments. The total expenses of the medical insurance plan were \$123.3 million. The amount is primarily composed of health insurance premiums and actual medical expenses. As detailed below, the defined benefit plan incurred a total of \$902.3 million in expenses:

EXPENSES	(MILLIONS)
Benefits	\$ 885.3
Refunds	10.5
Administration	6.6

Pension benefits paid to retirees and beneficiaries increased \$68.2 million bringing total benefit payments to \$885.3 million. Refunds of contributions paid to former members upon termination of employment increased from \$9.9 million to \$10.4 million. Administrative expense increased by \$190 thousand, or 2.97%, due primarily to an increase in personnel needed to administer the Retirement System.

## Investments

The investment portfolio's earnings represent a substantial financial contribution to the System. Income from investments provides most of the funds used in paying member annuities. The investment portfolio experienced significant growth during the 2003-04 fiscal year. The portfolio's par value increased from \$12,408,854,843 to \$12,742,427,524. The growth of the portfolio primarily was due to investment income that included realized capital gains. Employer and employee contributions also provided significant income to the portfolio.

Investment earnings, including appreciation of asset values, net of investment expenses for the 2003-04 fiscal year were \$1,165,314,842. The majority of earnings from the System's investment portfolio was the result of net appreciation in fair value of investments in the amount of \$763,174,844. The second largest earnings component, \$256,193,760 was the result of interest income. Other income of \$150,562,901 was generated from dividends, rent and securities lending.

According to KRS 161.430 the KTRS Board of Trustees has the authority to invest the assets of the System. The Board of Trustees, generally, delegates investment authority to an Investment Committee that is comprised of two Trustees and the System's Executive Secretary. The Investment Committee works closely with experienced investment counselors, who are contracted by the Board of Trustees, and the System's professional staff in evaluating and selecting investments.

## Funding

Based on recommendations of the Board of Trustees, the General Assembly establishes the levels of contribution by statute that are to be made by members and employers to fund the liabilities of the system. Each year, an independent actuary performs a valuation to determine whether the current levels of contribution will be sufficient to cover the cost of benefits earned by members.

The latest actuarial valuation was for the period ending June 30, 2004. This report reflects the System's assets, based on modified market value; totaled \$14.2 billion and the liabilities totaled \$17.6 billion. The actuary determined that the existing levels of contribution by members and employers would be sufficient to fund all of the System's liabilities within a reasonable period of time. The report concludes that the System is operating on an actuarially sound basis. Assuming that employer contributions continue in the

future at rates recommended on the basis of the successive actuarial valuations, the actuary states that the continued sufficiency of the retirement fund to provide the benefits called for under the System may be safely anticipated.

### **KTRS Medical Insurance Plan**

KTRS health care costs keep escalating at a much faster clip than revenue growth in the Medical Insurance Plan. Last year, basic doctor/hospital costs and the cost of medications (prescription drugs) rose about 6.4%. An actuarial valuation of the Medical Insurance Plan for the fiscal year ended June 30, 2004 indicated that the fund has an unfunded liability of \$3 billion for 2004. The KTRS 2002-2004 biennial budget requested additional funding from the Commonwealth, but due to difficult economic times, these funds were not available.

Effective January 1, 1999 KTRS retirees and dependents under the age of 65 have their health insurance provided by plans managed by the Kentucky Department for Employee Insurance. Under this arrangement, KTRS provides a monthly supplement to assist the retiree and their dependents in purchasing their health insurance. Retirees 65 and over remain in the plan administered by KTRS. These retirees also receive a supplement for the cost of their coverage.

The System realizes that these means alone will not solve the medical insurance funding crisis. Additional steps must be taken through legislation on both the state and national levels in order for true cost control to result. Meanwhile, KTRS will address the problem by taking measures to contain costs and by increasing revenues to the insurance fund, adjusting coverage to meet existing revenues, or a combination of the two.

### **Professional Services**

Professional consultants are appointed by the Board of Trustees to perform professional services that are essential to the effective and efficient operation of the KTRS. A certification from the certified public accountant and actuary are enclosed in this report. The system's consultants who are appointed by the Board are listed on pages 8 and 43 of this report.

### **Our Gratitude**

Mr. Earl Powell of Frankfort resigned from the Board of Trustees effective January 1, 2004. His service

began in 1986 and since 1991 he has served as Chairman of the Investment Committee. He has also worked at improving the retired teacher health insurance program.

Mr. Steve Hoskins of Wickliffe retired from the Board of Trustees effective June 30, 2004. Mr. Hoskins began his service in 2000 and served as Chairperson of the Legislative Committee and on the Personnel Committee and the Administrative Appeals Committee.

Mr. Powell and Mr. Hoskins were most dedicated members of the Board of Trustees and worked to protect the System as well as provide benefits for the active and retired members. We wish the Powells and the Hoskins many happy and productive years.

### **National Recognition**

The System was honored by two National professional organizations in regard to the administration of the retirement program.

### ***GFOA Certificate of Achievement***

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Teachers' Retirement System of the State of Kentucky for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2003. The Certificate of Achievement is a prestigious national award-recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such CAFR must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. The KTRS has received the Certificate of Achievement for the last sixteen consecutive years (fiscal years ended 1988-2003). We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to GFOA.

***PPCC Achievement Award***

The Public Pension Coordinating Council awarded a Certificate of Achievement to the Teachers' Retirement System of the State of Kentucky for 2004 for implementing and maintaining high professional standards in administering the affairs of the System. The award is based on compliance with principles judged to underlie exemplary retirement system achievements in the areas of benefits, actuarial valuation, financial reporting, investments and disclosure and are widely acknowledged to be marks of excellence for retirement systems. It represents the highest standards of excellence in the public pension industry.

The PPCC is a coalition of the four major public pension organizations in the nation. These include the National Association of State Retirement Administrators, The National Council on Teacher Retirement, the National Conference on Public Employees Retirement Systems, and Government Finance Officers Association.

**Acknowledgments**

The preparation of this report reflects the combined efforts of the KTRS staff under the leadership of the Board of Trustees. It is intended to provide complete and reliable information. This information serves as a basis for making management decisions and for determining compliance with legal provisions. It is also used to determine responsible stewardship for the assets contributed by the members and their employers.

This report is being mailed to all employer members of the System who form the link between KTRS and its members. Their cooperation continues to contribute significantly to the success of KTRS. Hopefully, the employers and their employees will find this report both informative and helpful.

KTRS is totally committed to the continued operation of an actuarially sound retirement system. The support that you have demonstrated in the past is an essential part of this commitment, and we look forward to continuing this good relationship in the future.

Respectfully Submitted,

**Gary L. Harbin, CPA**  
Executive Secretary

## BOARD OF TRUSTEES



**Virginia Murrell**  
Chairperson  
Retired Teacher Trustee  
Somerset



**Arthur W. Green**  
Vice Chairperson  
Teacher Trustee  
Elkton



**Julian M. Carroll**  
Lay Trustee  
Frankfort



**Robert M. Conley**  
Lay Trustee  
Paintsville



**Steven E. Hoskins**  
Teacher Trustee  
Wickliffe



**Ruth Ann Sweazy**  
Teacher Trustee  
Frankfort



**Laura Zimmerman**  
Teacher Trustee  
Flatwoods



**Gene Wilhoit**  
Ex Officio Trustee  
Commissioner,  
Dept. of Education



**Jonathan Miller**  
Ex Officio Trustee  
State Treasurer

**Kentucky Teachers' Retirement System**  
479 Versailles Road  
Frankfort, Kentucky 40601-3800

ADMINISTRATIVE STAFF

**GARY L. HARBIN, CPA**  
*Executive Secretary*

**C. JOE HUTCHISON, MBA, CPA**  
*Deputy Executive Secretary*

**STUART A. REAGAN, CFA**  
*Chief Investment Officer*

PROFESSIONAL CONSULTANTS

**ACTUARY**

Mellon Consulting Actuaries, Inc.  
Suite 1900  
200 Galleria Parkway NW  
Atlanta, Georgia 30339

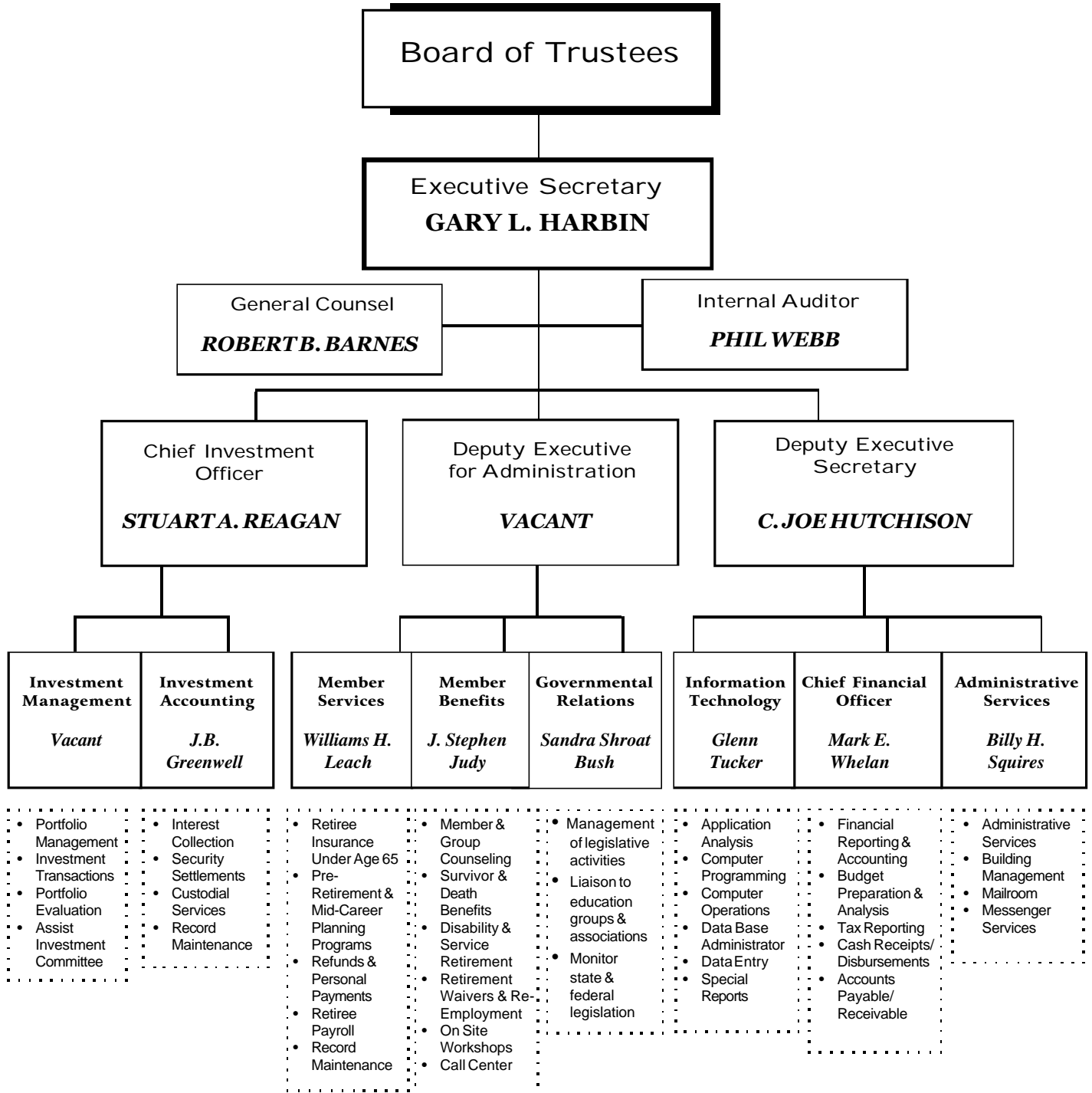
**AUDITOR**

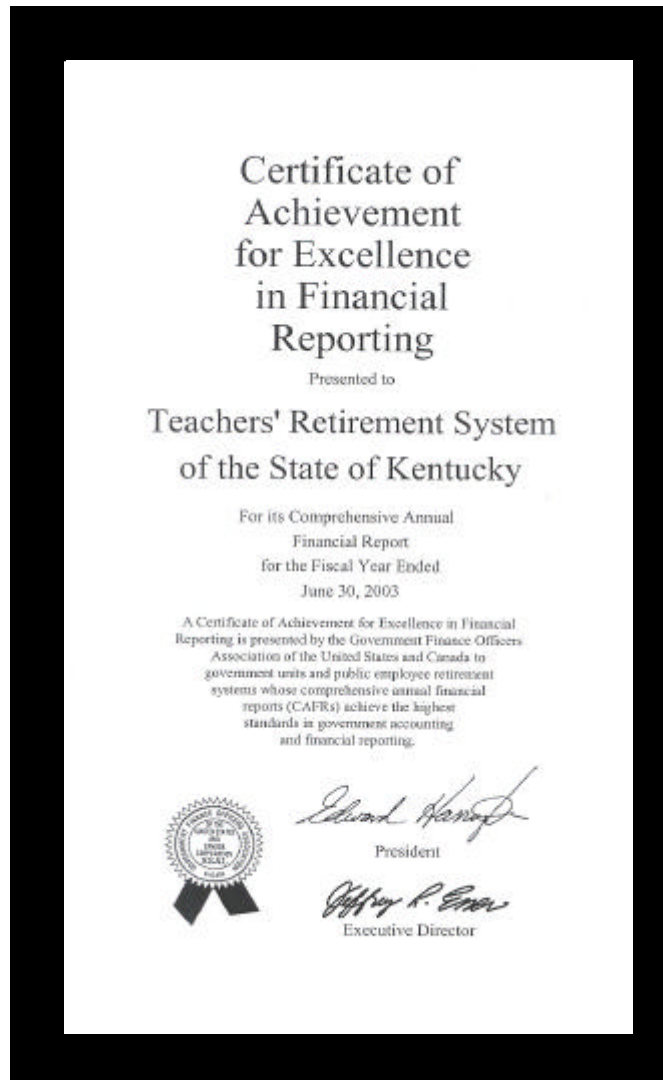
Charles T. Mitchell, LLP  
201 West Main Street  
P.O. Box 698  
Frankfort, Kentucky 40601

*\* See page 43 of the Investment Section  
for investment consultants.*



# KTRS Organizational Chart





## GOVERNMENT FINANCIAL OFFICERS ASSOCIATION (GFOA)

*The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Teachers' Retirement System of the State of Kentucky. The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Teachers' Retirement System of the State of Kentucky. The KTRS has received the Certificate of Achievement for the last sixteen consecutive years (fiscal years ended 1988-2003).*



**Public Pension Coordinating Council  
Public Pension Standards**

**2004 Award**

Presented to

**Kentucky Teachers' Retirement System**

In recognition of meeting professional standards for  
plan design and administration as  
set forth in the Public Pension Standards.

*Presented by the Public Pension Coordinating Council, a confederation of*

National Association of State Retirement Administrators (NASRA)  
National Conference on Public Employee Retirement Systems (NCPERS)  
National Council on Teacher Retirement (NCTR)

A handwritten signature in cursive script, reading 'Alan H. Winkle', is positioned above the printed name and title.

Alan H. Winkle  
Program Administrator

**PUBLIC PENSION COORDINATING COUNCIL  
PUBLIC PENSION STANDARDS**

*The Public Pension Coordinating Council awarded a Certificate of Achievement to the Teachers' Retirement System of the State of Kentucky for 2004 for implementing and maintaining high professional standards in administering the affairs of the System. The award is based on compliance with principles judged to underlie exemplary retirement system achievements in the areas of benefits, actuarial valuation, financial reporting, investments and disclosure and are widely acknowledged to be marks of excellence for retirement systems. It represents the highest standards of excellence in the public pension industry.*

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